DEBTOR IN POSSESSION FINANCING

I. PREAMBLE

Every industry has its slogans; debtor in possession financing (commonly referred to as DIP Financing) is no different. The First Lesson, "Your first loss is your best loss," may be somewhat contrary to the Second Lesson, "Pigs get fat; hogs get slaughtered." Such is the dichotomy that lenders face in dealing with a borrower's bankruptcy. Between this outline and the corresponding presentation, you will learn when it's best to fold your cards and take your loss, and when to stick around and ride the wave back to repayment (and even profit).

II. INTRODUCTION

Prior to the filing of its Chapter 11 case, the paramount concern for the debtor and its professionals will be financing the Chapter 11 case. The initiation of the Chapter 11 proceeding will certainly cause an immediate need for cash as lender, lessors, suppliers and customers come to grips with the bankruptcy filing. The following outline examines the issues surrounding the secured lender's post-petition financing of the debtor, the different types of financing, and how such financing impacts lessors, suppliers, customers and other creditors.

III. OVERVIEW OF SECTIONS 363 AND 364 OF THE BANKRUPTCY CODE

A. Cash Collateral (Section 363).

1. Section 363 of the Bankruptcy Code authorizes the debtor to use, sell or lease property of the estate in the ordinary course of business. Section 363(c) requires a debtor to obtain the secured party's consent or an Order of the Bankruptcy Court prior to using "cash collateral."

2. Cash collateral is defined by the Bankruptcy Code to include cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents, whenever acquired, in which the estate and an entity other than the estate have an interest. It includes the proceeds, products, offspring, rents or profits of property subject to a security interest, whether existing before or after the commencement of a case. A typical example of cash collateral is proceeds of accounts receivable and inventory.

3. Outside of the lender's consent, before authorizing the use of cash collateral, the court must find that the debtor can provide "adequate protection" of the creditor's secured interest. Since the "use" of cash collateral is tantamount to its consumption, the customary method of providing adequate protection is to provide replacement liens on post-petition inventory, receivables and their proceeds, for the use of pre-petition inventory, receivables and their proceeds. Adequate protection can also include cash payments sufficient to compensate for a decrease in the value of a secured creditor's liens or the granting of the "indubitable equivalent" of the compromised interest. Although "indubitable equivalent" is not defined, it typically connotes substituted collateral that protects the creditor's right to payment in the same manner as previously existed with respect to such creditor.

4. Use of cash collateral does not require the lender to make "new" advances; rather, the debtor finances itself through receivables collection and other proceeds raised during the bankruptcy. ***Practice Tip:*** Most courts do not consider advances made under a revolving line of credit to be "new" money if the revolver stays at the same level post-petition as existed pre-petition.

B. <u>DIP Financing (Section 364)</u>.

1. Unlike cash collateral, DIP Financing under Section 364 of the Bankruptcy Code contemplates advances not otherwise available to the debtor. This "new money" can be made available by the debtor's pre-petition lender or from a lender who begins lending money to the debtor after the filing of the bankruptcy.

2. If the debtor requires financing not within the ordinary course of business, it must first seek approval of the court. Section 364(b) provides that the court may, after notice and a hearing, authorize such financing. The claim of the lender providing such financing will be allowable as an administrative expense.

3. If the debtor is unable to find a lender willing to extend unsecured credit allowable as an administrative expense, Section 364(c) authorizes the court, after notice and a hearing, to grant to such lender (a) a super-priority administrative claim (having priority over all other administrative expenses); (b) a lien on property of the estate that is not otherwise subject to a lien; or (c) a junior lien on property of the estate that is subject to a lien.

4. If the debtor is unable to find a lender willing to extend credit on the foregoing terms, Section 364(d) authorizes the court, after notice and a hearing, to grant to such lender a "priming" lien that is senior to or equal to a preexisting lien on property of the estate. The grant of a priming lien requires that the preexisting lienholder be granted adequate protection of its interest in such property.

IV. <u>WHAT DOES "NOTICE AND A HEARING" MEAN</u>?

A. Often times, at the onset of a case, the debtor will immediately need cash to fund payroll, insurance or to pay necessary suppliers. In recognition of this fact, the Bankruptcy Code's requirement of "notice and a hearing" means such notice as is appropriate under the circumstances. In most cases, the debtor will seek, on an expedited (emergency) basis, an interim hearing on its motion to use cash collateral or to obtain DIP Financing.

B. With respect to the interim hearing, courts like to see as much notice, sent to as many of the affected parties, as possible. For the reasons set forth below, the order entered at the conclusion of the interim hearing is often to preserve the *status quo* and to avoid immediate and irreparable harm to the debtor; therefore, the debtor will be allowed to borrow only a limited amount pursuant to a court-approved budget for the interim period. In light of the short notice often given to creditors, the protections and benefits set forth in the interim order are not as extensive as the protections and benefits given in the final order.

C. The Bankruptcy Rules allow for the final hearing on the motion to use cash collateral or to obtain DIP Financing to be scheduled no earlier than 15 days after service of such motion.

D. ***Practice Tip****:* There can be dire consequences (including denial of special lender protections) if proper notice is not obtained. Accordingly, lenders should verify with their counsel that the notice requirements imposed by the Bankruptcy Code and Bankruptcy Rules are being met.

V. DOCUMENTING THE USE OF CASH COLLATERAL OR DIP FINANCING

A. In most Chapter 11 cases, the court will first enter an interim order. Approximately fifteen days thereafter, after notice of the final hearing is transmitted to all parties entitled to receive same, the court will enter the final order.

B. Generally speaking, the interim order and the final order are very similar. As stated above, given the abbreviated notice, the interim order will provide certain protections to the lender, but will not contain the entire breadth of protections the lender desires. The following provisions are commonly found in interim orders:

1. Authorization to use cash collateral and/or obtain DIP Financing through the hearing date on the final order, in such amounts as may be necessary to avoid immediate and irreparable harm, pursuant to a budget attached to the order;

2. Ratification of pre-petition loan documents (which often serve as the basis for post-petition use of cash collateral or DIP Financing) and pre-petition liens (if applicable), and waiver of claims against and defenses to payment of indebtedness, subject to the rights of non-debtor parties to review same and object thereto over a limited time period;

3. Acknowledgment of post-petition loan documents and post-petition liens (if applicable);

4. Super-priority claims for post-petition advances and to compensate for the diminution in the value of collateral;

5. Maintenance of lockbox or other method of segregating cash proceeds;

6. Events of default and corresponding remedies;

7. Granting of authority to debtor to execute additional required documents;

8. Access to inspect collateral;

9. Reporting requirements;

10. Procedures regarding application of payments received by debtor (see subsection "D" below);

11. “Carve-out” provisions allowing for limited funds to be used to pay professionals (the lawyers and accountants for the debtor and the creditors’ committee) and statutory fees due the United States Trustee;

12. Determination that proceeds of avoidance actions (preferences and fraudulent conveyances) are not part of post-petition collateral granted to lender, other than when lender provides DIP Financing and, in that case, only to the extent of the money loaned to the debtor;

13. Order binding on debtor (and, if possible, subsequently appointed Trustees); and

14. Determination that secured lender is not a “control person” for environmental or similar laws.

C. After the interim order is entered, debtor’s counsel will serve same, on at least fifteen (15) days’ notice to other parties-in-interest. During this time period, the Office of the U.S. Trustee will often attempt to appoint a committee of unsecured creditors to act on behalf of all unsecured creditors in that case. If a committee is appointed, it will hire counsel who will review the interim order and comment on the draft final order. After substantial negotiations with the debtor and the secured lender, committee counsel will attempt to obtain concessions from such parties. If the final order is agreed to, it is not uncommon to see these types of provisions (in addition to the provisions set forth above):

1. Requirement that debtor file a plan or sell substantially all or certain of its assets by date certain;

2. Time frame for creditors’ committee to object to the validity and priority of lender’s pre-petition liens;

3. Waiver of availability for debtor/trustee to surcharge collateral pursuant to section 506(c) of the Bankruptcy Code; and

4. Extended budget allowing for post-petition payments, without regard as to whether such payments are necessary to avoid immediate and irreparable harm. Budgeted line items will allow for payment to lessors, suppliers and creditors on account of post-petition goods and/or services.

D. ***Practice Tip*:** Courts strongly disfavor “cross-collateralization,” or the ability to secure pre-petition loans with post-petition assets. Accordingly, the following provisions typically are not allowable:

1. General provision stating that all pre-petition loans are secured by all post-petition assets (commonly referred to as “boot-strapping”); and

2. Provision allowing for all proceeds received by the debtor to be applied to pre-petition debt first, until such debt is paid in full, and then to post-petition debt (which is subject to stronger lender protections) (commonly referred to as a “roll-up”).

Boot-strapping and roll-ups, however, have been obtained in some instances where the lender advances significant funds post-petition in excess of the pre-petition balance, required by the debtor to continue to operate and, therefore, where the lender has significant leverage.

VI. TO BE A LENDER OR NOT TO BE A LENDER (THAT IS THE QUESTION).

A. There are several reasons why a pre-petition secured lender may consent to the debtor's continued use of cash collateral, including the following:

1. The continued operation of the debtor as a going concern (a) maximizes the value of the secured lender's collateral and (b) provides the debtor with time to return to profitability—thereby increasing the secured lender's chances of repayment.

2. An agreed cash collateral order typically provides extra benefits to the lender (*e.g.,* waiver of claims and defenses, "blesses" the validity and priority of the lender's liens and security interests, etc.) and (c) allows the secured lender to participate in all phases of the debtor's bankruptcy case—from the negotiation of the cash collateral order through confirmation of the plan of reorganization.

3. If the debtor can adequately protect its lender, the court may allow use of cash collateral over the lender's objection. If a lender with a security interest in cash collateral refuses to negotiate with the debtor over the use of cash, the court may authorize its use on terms less favorable than the lender otherwise could obtain through negotiation. In addition, the debtor could request authority to grant a priming lien under Section 364(d) to another lender.

B. There are several reasons why a lender may provide a debtor with DIP Financing:

1. If the DIP lender is also the pre-petition lender, the reasons set forth above continue to apply. In addition, since the lender is advancing new funds, courts are more willing to extend additional protections (such as liens on avoidance actions). ***Practice Tip*****:** The court can allow for the use of cash collateral over the lender's objection, but can never force a lender to lend new money.

2. DIP orders contemplate various types of fees (*e.g.,* origination fees, use fees, reimbursement of attorneys' fees, etc.) and various form of protections and benefits (*e.g.,* super-priority administrative claims, waiver of claims and defenses, etc.).

3. According to a February 20, 2002 article appearing in AMERICAN BANKER (see attached, in which Doug Lipke of Vedder Price is quoted), DIP lending is a lucrative and growing segment of the lending community. Consider the following:

   a. In the last twelve (12) months, the top ten DIP lenders (ranked by dollar volume) made ninety-one (91) DIP loans, in the aggregate amount of $9,603,100,000. In the last twelve (12) months, the top ten DIP lenders (ranked by number of loans) made one hundred thirteen (113) DIP loans;

b. DIP lenders traditionally experience default repayment rate on DIP loans to be less than 1%;

c. Certain DIP loans exceed $1 billion (KMart, WorldCom, UAL Corp.); and

d. DIP lending is competitive in virtually all segments of industry[1].

4. DIP Financing provides an excellent platform for a debt/equity swap and related benefits.

C. There are, of course, many reasons why secured lenders do not want to finance a Chapter 11 debtor, including the following:

1. The collateral base may be rapidly eroding (think Enron, Winstar, Montgomery Ward, Ben Franklin);

2. The continued operations of the debtor may lead to bigger losses due to market factors, company mismanagement, etc. (think “dot.coms”); and

3. Chapter 11 is increasingly being used as the forum to liquidate companies (think Outboard Marine, Montgomery Ward, National Steel). If the DIP lender did not carefully perform its due diligence, the debtor may only realize liquidation (or worse yet, fire sale) values on the lender’s collateral.

[1]See attached for various industry statistics (e.g., pricing, interest rate, comparisons by industry, etc.) concerning DIP loans.